

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
GARY R. AND G. MARGUERITE DAHL)

For Appellants: Edward R. **Galus**
Certified Public Accountant

For Respondent: Kathleen M. Morris
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Gary R. and G. Marguerite Dahl against a proposed assessment of additional personal income tax in the amount of **\$3,388.46** for the year 1976.

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This appeal presents two issues **for** determination: (1) whether appellants are entitled to a **loss** deduction for certain furniture and fixtures which were abandoned; and (2) whether appellants are entitled to a loss deduction for abandoned goodwill. A third issue involving the deductibility of certain expenses associated with appellants' rental properties has been conceded by appellants.

On April 15, 1976, Gary R. Dahl (hereinafter appellant) entered into an agreement to purchase a bar and cocktail lounge located in **Los Gatos**, California, and known as "Park Lounge." As specified in the agreement of sale, appellant acquired the right to use the seller's name and goodwill. However, the agreement did not allocate any portion of the sales price to goodwill. Appellant also acquired all the furnishings, fixtures, equipment, liquor license and inventory of the **business**. The agreement provided for a purchase price of \$58,000 which was allocated in the following manner:

(a) Seller's on sale general liquor license	\$20,000
(b) Seller's furnishings, fixtures and equipment	20,000
(c) Seller's advantageous lease and realty interest	12,000
(d) Seller's covenant not to compete	<u>6,000</u>
Total	<u><u>\$58,000</u></u>

Additionally, appellant entered into an agreement to lease the premises and improvements for the bar and cocktail lounge for a ten-year period.

Appellant took possession of the Park Lounge on May 17, 1976, and opened for business on June 1, 1976. Bar operations continued until June 29, when the bar was closed for remodeling, which began immediately. Appellant contends that after the original purchase, a more complete inspection of the premises revealed for the first time that the Park **Lounge was** in a serious state of disrepair and that substantial remodeling was required. According to appellant, it was after this inspection that the decision to remodel was made. Appellant also contends that in late June the furniture

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and fixtures remaining in the bar were scrapped. Construction costs for the remodeling exceeded \$110,000. In addition, appellant purchased new furniture, fixtures and equipment at a cost in excess of \$35,000. On November 1, 1976, the Park Lounge was reopened under a new name, Carry Nations.

On appellant's 1976 return he deducted \$20,000 for scrapped fixtures and \$6,000 for abandoned goodwill. The deductions were denied for lack of substantiation.

The first issue is whether appellant is entitled to an abandonment loss. Section 17206 of the Revenue and Taxation Code and the regulations thereunder specifically allow a loss deduction where depreciable assets are retired by actual abandonment and provide that the amount of the loss is to be measured by the adjusted basis of the abandoned assets. The burden of establishing his right to claim a deduction for an abandonment loss is, of course, on the taxpayer. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Appeal of Frank G. and Joan Cadenasso, Cal. St. Rd. of Equal., April 10, 1979.)

In order to claim the deduction, the taxpayer must establish that the abandonment occurred as the result of a plan formed after the acquisition of the property that was abandoned. (First National Bank & Trust Co. of Chickasha v. United States, 462 F.2d 908, 909 (10th Cir. 1972); Appeal of Frank G. and Joan Cadenasso, supra.) Where the taxpayer purchases property which includes furniture and fixtures, and at the time of purchase intends to abandon the furniture and fixtures, he is not allowed a loss deduction on account of the eventual abandonment, but must allocate the basis of the abandoned property to the remaining property. (Wood County Telephone Co., 51 T.C. 72, (1968).) Whether the taxpayer in this appeal purchased the Park Lounge with the intention of abandoning the furniture and fixtures is a factual question. The parties to this appeal, of course, have taken contrary positions. However, it is not necessary to reach this question because we believe appellant's claim must be **rejected** for failure to identify the specific property which was abandoned and its adjusted basis.

Appellant has submitted an exhibit to the agreement of sale which contains a list of the furniture and fixtures which were transferred. Initially, appellant claimed that all of the items listed were

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abandoned. Later, however, he admitted that one major item on the list, a large floor safe, was not abandoned. When the list is compared with a compilation of replacement assets acquired during the remodeling period, it becomes apparent that many of the essential assets allegedly abandoned were not replaced. For example, **the** original list included, inter alia, a gas heater, cabinets, 220 glasses, and **various dispensers** and coolers. The record does not indicate that any of these items, along with several others, **were** ever replaced. Furthermore, the list included such common items **as** a file cabinet, a desk, an adding machine, cleaning equipment and a fire extinguisher. Not only does the record fail to indicate that any of these items were replaced, but it is also questionable whether these common items would be abandoned in view of their utilitarian nature. It is **undoubtedly** true that some items of furniture and fixtures which were replaced, such as tables, chairs,, stools, a cash register and air conditioning equipment, were abandoned. However, appellant has failed to establish the specific assets abandoned; their adjusted basis and their salvage value. For these reasons, appellant's claimed abandonment loss must be denied. (See Southern Engineering and Metal Products Corp., ¶ 50,035 P-H Memo. T.C. (1950).)

Next, appellant contends that he is entitled to claim a loss deduction for abandoned goodwill. Such a deduction is allowable under section 17206 of the Revenue and Taxation Code. However, the burden of proving the existence and the valuation of goodwill is on the taxpayer. (Wilmot Fleming Engineering Co., 65 T.C. 847, 860 (1976).)

Essentially, the goodwill of a business is the potential of that business to realize earnings in excess of the amount which might be considered a normal return from the investment in the tangible assets. (Ervin D. Friedlaender, 26 T.C. 1005, 1017 (1956).) In the agreement of sale in the present appeal, there is no allocation of consideration to goodwill, although goodwill is specifically mentioned' in the agreement. The failure to allocate any amount of the agreed upon purchase price to goodwill is good evidence that no such allocation was intended. (Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962).) Furthermore, appellant has offered no other evidence tending to establish either that any goodwill in fact existed, or if it did, what was its value.

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In this appeal, \$6,000 of the purchase price was allocated to the seller's covenant not to compete. In some cases, where the covenant not **to compete** is so closely related to a sale of **goodwill** that it has no independent significance apart from assuring the effective transfer of goodwill, the covenant and goodwill are treated as one **and** the same. (See, e.g., Barran v. Commissioner, 334 **F.2d** 58 (5th Cir. 1964); Schulz v. Commissioner, 294 **F.2d** 52 (9th Cir. 1961).) Again, however, the burden of proving such inseparability is on the taxpayer. (Wilmot Fleming Engineering Co., supra.) Appellant has offered no evidence on this **issue**.

Since appellant has failed to satisfy the burden of proving his entitlement to a deduction for abandoned goodwill, respondent's action in denying the claimed deduction must be sustained.

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ORDER

Pursuant to the views axpressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Gary R. and G. Marguerite Dahl against a proposed assessment of additional personal income tax in the amount of \$3,388.46 for the year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day
of July , 1981, by the State Board of Equalization,
with Board **Members** Mr. Dronenburg, Mr. Reilly, Mr. Bennett
and **Mr.** Nevins present.

<u>Ernest J. Dronenburg, Jr.</u>	, Chairman
<u>George R. Reilly</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Richard Nevins</u>	, Member
	, Member